Administrative Regulation and Judicial Interpretation Under the Securities Exchange Act of 1934

The Securities Exchange Act \(^1\) was enacted in 1934 with the dual intent of eradicating unfair and manipulative trade practices in securities markets and of regulating the amount of the nation's credit which might be diverted from

more productive fields into the realm of security speculation. Thus, the Act was designed not only for the protection of uninformed and innocent investors, who have in the past become victims of unscrupulous price manipulations, but also for the protection of the multitude of persons whose welfare is directly affected by the availability of credit, at reasonable rates, to the nation’s business enterprises. In view of the difficulty of achieving, in a single act, both of these ends or either of them to its fullest realization, the statute has been broadly drawn with extensive powers of interpretation and rule making vested in the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System.

During the four years which have elapsed since its enactment, judicial interpretations have been surprisingly scarce. Furthermore, these few decisions have been limited to a definition and exposition of permissible practices under the Act and to a review of the administrative procedure of the Commission. On the other hand, the Commission has published voluminous decisions interpreting almost every section, together with numerous supplementary rules. In addition to these formal utterances, countless informal opinions have been rendered by the departmental directors, general counsel, and other officers of the Commission, published in the form of daily releases to the press and the interested public.

At its inception, learned writers speculated as to possible achievements under the Act. Now, however, an opportunity is presented to consider its actual effect by means of official interpretations of the Act. In view of the extensive scope of the Act and the limited number of situations which have so far arisen thereunder, it is evident that present compilations and classifications cannot be regarded as final. In fact, there have been no public interpretations of many of the less important sections of the Act. Consequently, the treatment of these sections has been omitted. However, a rather complete picture of the provisions pertaining to registration and licensing may be gathered from the rules and opinions and, consequently, considerable discussion may be devoted to this problem. Questions involving the use of registration and report forms will be omitted except where some general declarations have been manifest, as the forms themselves contain exhaustive explanatory material. Inasmuch as the available source material fails to present a complete exposition of all fields of the Act, the functional approach has yielded, largely, to the annotation, thus forming a picture of what has resulted under the Act rather than a discussion of particular problems in the field of securities.

Few definitions have been added to the long list of essential terms defined in section 3. However, two rules of the Commission have defined “listed” as meaning “admitted to full trading privileges”; and “officer” as the president, vice-president, treasurer, secretary, comptroller or any other person performing a corresponding function for the issuer. The term “exempt security” under subsection (a) (12) has been extended to include the securities of the Federal Home Loan Bank Board and The Federal Home Loan Bank, farm loan bonds issued by the Federal Land Bank, and debentures issued by the Federal Credit


3. Securities and Exchange Commission Rules AT 1 and AT 2. (Hereinafter Rules will be referred to merely by number.)

Bank. Furthermore, securities, the interest on which is guaranteed and the issuer of which is managed by a political subdivision, are "exempt securities" so long as the liability and control by the political subdivision continues.

**Exempt Exchanges.** Under section 5, providing that exchanges be either registered or exempt from registration by the Commission, conditions have been set up requiring an exempt exchange, in order to retain its exempt status, to keep the information on its application up to date and available to the public, to keep certain records, apply credit restrictions to securities listed on the exchanges as if they were registered, subject members to the Act, and grant no new unlisted privileges. A further requirement has been promulgated to the effect that issuers subsequently listing securities on these exchanges file the same information as if the exchanges were registered. Furthermore, securities listed on the exchanges are given the same status as temporarily registered securities and must be registered when the exchange is registered, although the exemptions of an unregistered security apply.

Two rules have been promulgated under section 6, governing the registration of national securities exchanges, requiring such exchanges to file promptly amended registration statements showing current changes in their status, such requirement being interpreted to mean "as soon as reasonably practicable"; and to make public all statements and exhibits in its registration statement and information filed with it by issuers, upon registering a security and making reports. In the event that an exchange should withdraw its registration, it may be reinstated if it preserves its assets, prohibits the trading of seats, and otherwise maintains its status quo.

**Credit Restrictions and Exemptions Therefrom.** Section 7 deals with margin requirements. Here Congress has delegated to the Board of Governors of the Federal Reserve System, the power to make rules limiting the extension of credit on registered securities. Strangely enough, and this may account for the selection of the Board rather than the Commission as the recipient of this power, the purpose of these rules was not to regulate the individual broker-customer transaction, concerning which the exchanges are usually effective, but to create a method of controlling the amount of national credit which might be diverted into security speculation and, thus, away from other fields of investment. Pursuant to the terms of the Act, the Board of Governors has established numerous provisions for the regulation of credit extension under this section, with the present basic requirement that the maximum loan value of a registered security shall be 60 per cent of the current market value and dropping entirely the alternative of a percentage of the lowest market value during the last three years.

One of the earliest declarations by the Commission, in respect to this section, subjected to the same privileges as registered and exempt securities under subsection (c) (2), non-registered securities which have been granted trading privileges on unregistered exchanges, and listed securities exempted from registration under section 12 (a), with regard to which subsequent rules have been issued bringing such securities under the operation of this Rule. These

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6. Rule AN 5.
8. Rule CB 3.
10. Rules UB 1 and UB 3.
Rules include the extension of the privilege to the securities of foreign states governed by interim regimes, the securities of banks and bank holding companies, the securities of firms in bankruptcy, receivership, or reorganization under section 77 or 77B of the Bankruptcy Act, securities evidenced by an instrument evidencing another listed security, and securities resulting from a modification or exchange of securities of former corporations.

Prosecution of Manipulative Practices. Under section 9, making manipulative practices such as matching, pegging, and other price fixing schemes unlawful, certain essential elements of such practices have been considered by the courts and the Commission. For example, the element of “knowledge” of companion orders necessary for a violation of the prohibition against matching orders in subsection (a) (1) is required to be affirmatively proved and cannot be inferred from the mere fact of a telephone conversation between the parties. Similarly, in the leading case of Matter of Meehan, the Commission held that knowledge cannot be inferred from the buying produced by rumor circulated by the defendant, from the buying of his business partner, of his secretary, or of a friend unless it were affirmatively shown that such orders were entered at the defendant’s “behest.” On the other hand, where there was a purchase by a specialist from Meehan’s broker at Meehan’s request, and where there were transactions between two accounts for which Meehan held powers of attorney, there existed definite proof of matched orders in violation of the Act. These latter transactions were consummated through the same broker, and although such “crossing” may be legal per se, the transaction is illegal when matched orders result.

In several decisions, courts have entertained the problem of whether or not certain factual situations resulted in artificially raising prices for the purpose of producing trading in contravention of subsection (a) (2). A syndicate in Chicago effected a series of transactions raising the price of a security by disseminating information extolling a proposed manufacturing plan, prospective profits, and dividends of a corporation of which the members were officers. The purpose was, of course, to induce purchases of such security from the syndicate. Without deciding whether the information were true, the court enjoined the practice. The Commission, in the prosecution of Meehan, found that the combined factors of stimulation by defendant of reports concerning his interest in the Bellanca corporation, the concealment of his sales of the stock of that corporation, and the perpetration of matching orders—the incentive for these acts being his underwriting agreement to sell Bellanca stock—resulted in a violation of this section. Under the terms of Meehan's contract, in order to make a profit, it was necessary to sell well above the prevailing market quotations.

15. Rule AN 21 promulgated in Release No. 657, May 7, 1936, provided for an exemption of 30 days, and was amended eight times culminating in Release No. 1504, Dec. 27, 1937, providing for a 60-day exemption.
16. Rule AN 8, providing for an exemption of 120 days.
17. Rule AN 11, providing for an exemption of 10 days. On the question of what securities are exempt under this rule, see Legis. (1934) 34 Col. L. Rev. 1348.
18. Rules AN 19 and AN 20, providing for an exemption of 10 days.
19. Rule AN 23, providing for an exemption of 7 days.
22. See, for example, cases cited in Release Nos. 1144, April 13, 1937, and 1166, April 27, 1937.
24. Supra note 21.
Two cases have arisen where transactions, legal prior to the passage of the Act, were held not to be infringements. In *S. E. C. v. Otis* \(^{25}\) the court denied an injunction where an agreement was made between the vendor and vendee of a block of stock that the former would withhold from sale the balance of the block for a period of sixty days. The court declared that there was no showing of a purpose on the part of the vendee to induce the purchase or sale of stock by others, but merely to insure an orderly market for the disposition of the stock to his regular customers. Great weight was attached to the fact that such withholding agreements were formerly legal. The second case, *S. E. C. v. Torr* \(^{26}\) involved payments to persons in the securities business for the purpose of inducing the purchase of Translux stock by means of truthful statements. The District Court enjoined this practice but the Circuit Court of Appeals reversed the decree in the absence of evidence of future violations. This finding was predicated upon the conduct of the defendant in making a genuine effort to comply with the Act, inasmuch as the practice was theretofore legal, and in ceasing the payments when advised of their invalidity. The illegality of the practice was not considered on appeal, but Judge Learned Hand dissented on the ground that there was no evidence that the practice would be discontinued and declared, in addition, that this activity definitely contravened the Act. No Rules have been promulgated by the Commission; however, the General Counsel has issued an opinion to the effect that this section applies, as well, to transactions effected in an agency capacity.\(^{27}\)

In the foregoing opinion, it is asserted that subsection (a) (6) should indicate conclusively that stabilization in the absence or not in contravention of such “rules or regulations as the Commission may prescribe,” is not illegal. However, Mr. Meehan, \(^{28}\) by way of defense to charges lodged against him, asserted that his “bulling” Bellanca stock, matching orders, and other activities, were merely pegging transactions and thus came within the purported immunity of subsection (a) (6). The Commission, however, examining the background and purposes of the transactions, found that the practices constituted unlawful manipulation. Under this decision it may be assumed that the Commission recognizes no immunity under subsection (a) (6) in view of the fact that undesirable transactions resulting in pegging will be suppressed under other provisions of this section, particularly subsection (a) (2).

**Short Selling Inhibited.** Early in 1938, the Commission determined that the rules of the exchanges regulating short selling were ineffective. Consequently, in furtherance of section 10, which restrains short sales and makes it unlawful to engage in other deceptive practices, short selling in a declining market is prohibited.\(^{29}\) A short sale is now defined as any sale where the seller does not own the security or which is consummated by delivery of a borrowed security, except where it is inconvenient or too expensive to deliver the stock which the seller owned. Such a sale is prohibited except at a price above that of the last market transaction. Another ruling requires that the seller’s position in all sales be marked long or short. Odd lot transactions and transactions, executed with the approval of the exchange, to equalize the price of the security with that of another exchange are exempt. The Director of the Trading and Exchange Division of the Commission, in approving the N. Y. Stock Exchange’s interpretation of the short selling rules, indicated that a person is an

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owner of a security when he has title to it, or is a party to an unconditional contract to buy it binding on both parties, or has tendered for exchange a security convertible into it, or has exercised an option to buy it, or has exercised a right or warrant to receive it. Further, a person owns a security only if he is "net long" in it on all of his accounts. However, brokers have attempted to avoid this regulation by placing orders on their own exchange through London. This surreptitious scheme circumvents both the marginal requirements and the short selling prohibition inasmuch as the Commission has no means of verifying the seller's position.

Turning to subsection (b), which prohibits the use of outlawed practices, we find that the Commission has extended the prohibition contained in this section to transactions in securities exempt from registration under section 12 (a) (1) regarding which securities, the Commission has promulgated rules which bring them within the operation of this rule. As respects this class of security, a transaction falls within the prohibition of section 10 (b) if it would have violated section 9 (a), had a registered security been involved. In view of the fact that this section specifically includes all non-registered securities, there is doubt whether this Rule adds anything to the basic meaning of this section. Furthermore, in a companion rule, the Commission has prohibited persons financially interested in the distribution of a particular issuer, from paying for the solicitation of the purchase or sale of securities of the same issuer for the account of any other than the one furnishing the consideration for the solicitation. This, however, does not apply to regularly salaried employees paid for their ordinary duties of solicitation of brokerage orders.

The Curbing of Specialists and Broker-Dealers. Little has been said concerning the construction of section 11 which provides for the promulgation of rules regulating exchange trading, specialists, and the transactions of persons acting both as brokers and dealers. The Commission has issued minor explanations of the regulations regarding specialists set forth in subsection (b) (2) to the effect that specialists must affirmatively justify their transactions if questioned. In determining whether a transaction was "reasonably necessary" to maintain an orderly market, the immediate conditions both of the market and of the specialist's book must be considered. Three types of specialist's transactions not reasonably necessary are set out: (1) purchase above or below the last sale price, (2) purchase of all of the stock offered on the specialist's book at the last sale price, (3) supplying all of the stock bid at the last sale price, or any other transaction cleaning up the market under similar circumstances, whether effected by book or not.

Under subsection (d), a broker is exempt from adherence to the provisions of section 7 regarding the extension of credit on securities which he is distributing if (1) he has not sold to, or bought for, a customer, (2) the security is issued to the customer in exchange for another, or (3) the customer is a broker, dealer or bank. In regard to the extension of credit, the General Counsel has declared that the phrase in subsection (d) (2) requiring a broker to disclose his capacity "at or before the completion of the transaction," must be read in the light of the purpose of the Act to effect notice to the customer before he changes his position. If the customer is purchasing, this phrase means when

32. Rule GB 1.
33. Rule GB 2.
34. An opinion by the Director of the Trading and Exchange division sets out five of the more common situations where this rule is violated, Release No. 1411, Oct. 7, 1937.
he pays for the security; if selling, when he delivers the securities—either physically or by bookkeeping entry. On its face this would not seem to give the customer much protection, inasmuch as he is bound by his contract before executing it.

**Securities Exempt from Registration.** Under section 12, providing for registration and withdrawal of issued and unissued securities, and the extension to such securities of unlisted privileges on national exchanges, the Commission has promulgated several rules temporarily exempting securities from the necessity of being registered in order to make trading lawful on the exchanges. Ninety day warrants issued on listed securities, and such securities which are exempt from marginal requirements under section 7 (c) (2), are temporarily exempt from registration for such purposes. However, it is important to note that securities exempt from registration are subject to the prohibition against the use of any manipulative device regarding trading in them. Securities may be suspended from trading privileges, by action of the exchanges for infractions of their rules, but this does not terminate registration.

In view of the completeness of the Commission's instructions concerning methods of registration, little can be added in that regard. However, the general criterion for the standard of information in the application has been defined as the setting forth of those facts about which "an average prudent investor ought reasonably to be informed." A few rules dealing generally with applications and reports have been promulgated allowing incorporation by reference with permission of the Commission, of other documents filed with the Commission, the Interstate Commerce Commission and the Federal Communications Commission, and allowing the reservation of constitutional rights as to any application. Where an exchange certifies a security for registration and the security complies with proper forms under the Act and Rules, the Commission cannot deny registration merely because, in their opinion, the security is not suitable for trading on an exchange.

**Withdrawal of Applications.** It has been ruled that applications for withdrawal from registration and listing pursuant to subsection (d) must set forth the reasons and material facts, and, if uncontested, the applicant need not appear at the hearing, but can offer the application in evidence. Prior to the promulgation of this Rule, an application had been rejected because the applicant did not appear at the hearing and sustain the burden of establishing the facts with respect to the application. Shortly thereafter, the Commission accepted, as evidence, an affidavit stipulated by both parties to be part of the record of the hearing and thereby relieved the applicant of the necessity of appearing. Thereupon, the Rule was promulgated by the Commission sanctioning this procedure. In the event that sufficient facts are not set forth at the hearing to enable the Commission to determine what measures, if any, are necessary for the protection of investors, the application will be dismissed.

38. Ibid.
40. Supra notes 15-19.
41. Rule GB 1.
42. Rule JD 2.
45. Rule JB 5.
47. Rule JD 2.
48. Ibid.
51. Supra note 46.
Issuers are required to withdraw their registration when the security has matured, retired or been redeemed,\(^5\) or the obligation substantially altered,\(^6\) and an exchange may terminate listing and registration if there is insufficient trading interest\(^6\) or if the trading is terminated and the security is registered on another exchange.\(^{5,6}\) An exchange may also secure delisting of a security under certain circumstances, to wit: when most of the trading in the security is by interested parties; or when such trading is primarily accomplished by wash sales; or when no bona fide market for that security exists; or when the registration statement has been improperly certified\(^6\); or when there is mismanagement of the issuer.\(^{5,7}\) However, such application on the part of the exchange will be denied if the grounds for such application have been removed before the hearing thereon.\(^{5,8}\) Other reasons for withdrawal include cases where the property pledged as collateral for bonds is sold and the bonds are rendered valueless\(^6\); where the corporation is being reorganized\(^6\) under section 77B of the Bankruptcy Act, or is in bankruptcy\(^6\); where there is a reorganization of the capital structure and the issuance of new shares in place of the present class\(^{6,2}\); where a reorganization plan remains undisposed of for two years\(^{3,3}\); where the majority of the stock is subordinated to certificate holders in a liquidation proceeding\(^6\); where the expense of keeping registration up to date is deemed to be too great\(^6\); or where the stock is valueless due to the failure of subsidiaries.\(^{6,6}\) With respect to this last situation in the *Allen Industries* case, the Commission declared that it was not called upon to determine the value of the stock, but that if the exchange had acted in bad faith in certifying the stock to be valueless, it could be disciplined. However, the Commission may inquire into the motives for delisting in order to determine whether such action was taken to enable controlling shareholders to increase their holdings, and whether the management acted in good faith. Inasmuch as this case involved a large corporation, delisting was granted after a two weeks period to allow for the readjustment of accounts holding this stock as collateral. In this case, the exchange objected to the withdrawal of listing on the grounds that the cost to investors would be increased if transactions in the security could be consummated only on the remaining exchange. But the Commission concluded that it had no power to deny the application as long as the rules of the exchange were complied with and the withdrawal was not too abrupt. The listing agreements with the exchange do not constitute a contract which can be enforced to stop the withdrawal. The Commission itself may order the withdrawal where the certification to the registration statement is not filed,\(^{6,7}\) or where the financial statement is not furnished.\(^{6,8}\)

\(^{52}\) Rule JD 3.

\(^{53}\) Rule JD 2.


\(^{55}\) Rule JD 2.

\(^{56}\) Supra note 50.


\(^{58}\) Ibid.


\(^{60}\) Release No. 86, January 22, 1935.


\(^{63}\) Release No. 690, May 19, 1936.


\(^{67}\) Matter of Dolphin Paint and Varnish Co., 1 S. E. C. 879 (1936).

\(^{68}\) Release No. 96, Feb. 11, 1935.
Regarding the registration of unissued securities, the Commission has promulgated a full set of regulations. These define a warrant as any evidence "of a right to subscribe to . . . or otherwise to acquire an unissued security." Such warrants may also be registered for "when issued" dealings, as may other securities. Registration of an unissued security may be denied, revoked, or suspended if provisions of the Act are not satisfied, or there is subsequently any transaction creating a false, misleading, or artificial appearance of activity.

Trading Privileges in Unlisted Securities. Pursuant to subsection (f), it has been ruled that any exchange may apply for continuance or extension of unlisted trading privileges. Several cases have arisen in which the Commission has attempted to define the elements necessary for approval of unlisted trading privileges. An application under subsection (f) (i) for continuation of unlisted privileges was denied because trading had been suspended for over two years from October, 1934. Hence, the purpose of the section to avoid the immediate severance of trading privileges granted prior to the adoption of the Act would not be fostered. The provision is anomalous as it does not require filing full and complete information; consequently, it should not be extended.

In considering applications under subsection (f) (2) for the granting of unlisted privileges, the Commission has approached the matter by first making a finding on the sufficiency of distribution in the vicinity of the exchange upon which the unlisted privilege is sought. One suggested test for determining the meaning of "vicinity" was the area of distribution of a stock of like kind. This was discarded in favor of the area through which the exchange quotations were distributed by branch offices, wire service and newspapers. However, in the latter decision, it was considered that something more than evidence of circulation of information was required; consequently, "vicinity" is now defined as "the particular geographical section in which a particular exchange ranks as the one . . . to which investors would look for an exchange market." Weight can be given to evidence of underwriting and over-the-counter transactions by exchange members.

The next problem under this subsection is the meaning of "sufficient public trading," both on over-the-counter markets and on the exchange itself, regarding which the evidence of trading of similar securities of the same company is relevant. The machinery of the exchange was examined in one instance, and where it was found that the odd lot trading was so geared to the primary exchange that the customer received the benefit of the better price, the application was approved. Other elements considered included a comparison of the commissions and differentials on the applicant and primary exchanges; the number of local issues on the list; the saving of time and interest money by transactions on the applicant exchange; the number of securities held in street name and beneficially owned in the vicinity; the trading in New York which originated in the vicinity, but which was executed through New York banks; and the trading on the over-the-counter markets in the vicinity. All these figures should be classified as to round and odd lots. The question of difference

69. Rule JD 4.
70. Rule JF 1.
76. Supra notes 74, 75.
77. Supra notes 72, 73.
78. Supra note 72.
79. Supra note 73.
80. Supra note 71.
in tax laws between the primary and the applicant exchange is not considered, although it is a factor where the broker assumes the state transfer tax. But if the market in bonds is not geared to the primary market and business will probably remain with the over-the-counter market, only on exceptional conditions will the privilege be granted.

The second criterion to be observed is whether the privilege is "necessary and appropriate in the public interest." In the case of Edison Electric Illuminating Company it was said that it is not "necessary" to have an exchange market where a well informed public can easily determine the over-the-counter prices and the character of the general market. On the question of "appropriateness," the Commission further opined that it need not find that either the exchange or the over-the-counter market is better adapted to trading in that particular issue, as all that is comprehended by the Act is that each market grow according to its own genius. Where the round lot market does not establish an independent secondary market, but is geared to the primary exchange with no provision for reflection of the secondary market sales in the price, the presumption is against "appropriateness." On the other hand unlisted privileges will be denied for round lot dealing, despite the existence of adequate machinery, if the round lot transactions have constituted only 8 per cent of the total trading.

Securities granted unlisted trading privileges under this section are extended certain exemptions. Where none of issuer's securities are registered on the exchange which has granted the unlisted privilege, the issuer enjoys an exemption from filing reports with the exchange under section 13. Likewise, where none of issuer's securities are registered on any exchange, the issuer enjoys the same immunity as respects reports to be filed with the Commission. A similar exemption applies to section 14; and no reports need be filed pursuant to section 16 unless the security is registered, in which case, the exemption under that section applies to holders of more than 10 per cent of the issue.

Applications for the termination of this unlisted privilege may be made by the issuer, a broker, dealer, or exchange. However, no change in the unlisted status is necessary where changes are made in the security, unless the Commission finds them to be substantial. Similarly, the unlisted privilege is not terminated where one exchange absorbs another. Lack of public distribution was assigned in the case of Matter of Security National Bank as the reason for the application for termination of the privilege. The application was allowed despite a finding that the real reason was the desire on the part of the issuer to be exempt from marginal requirements. Furthermore, the Commission must find that the termination is necessary for the public interest or protection of investors. This element was deemed to be present where the exchange quotations on the security were ten to fifteen points under the over-the-counter prices, thus creating a potential injury to public trading as dissemination of the exchange prices
would disturb the orderly over-the-counter market.94 In the case of American District Telegraph Company,95 the Commission permitted the withdrawal of unlisted privileges because inadequate public trading resulted from odd lots specialists doing all the trading in round lots and thus creating a private dealers' market within the exchange.

Reports of Issuers. Under section 13, requiring the issuer to file information and reports with the Commission and exchange listing its securities, annual reports are required 96 of the issuers of registered securities, except where 97 the application for registration of the security includes the same information. Where more than three months elapsed between the period covered by the application and the annual report, interim reports are required.98 If major changes in the status of the security or issuer take place, the information is required 99 to be reported currently. In making all reports, the accounting systems required by other Federal Acts may be used.100

Proxy Requirements. Pursuant to section 14, authorizing the Commission to supervise the use of proxies, two Rules have been issued 101 making the scope of solicitation regulated by the Act very broad and inclusive, excepting solicitation by banks, dealers or brokers with respect to their securities where nothing is paid for the solicitation, and also trustees and beneficial owners. These Rules also require that information identifying the solicitor and his plan of action be set out in the solicitation, prohibit false statements, require copies of the proxies to be filed with the Commission and the exchange, provide for the solicitation of the same persons by the issuer on request of a security holder, and provide that nothing in the Rules pursuant to section 14 shall limit the authority of, nor invalidate the action of the proxy holders. This section, according to the opinion of the General Counsel,102 does not include solicitation of approvals or assents which are part of proceedings under 77B or of a protection committee for the securities. The "brief description," required by the Rules, of the matters to be considered at the meeting where the proxy is to be used means "a concise description of the substance of each of the various matters to be considered." 103 But if the matters are of a routine or recurrent nature, a general description will suffice. Moreover, if the business to be considered is merely the approval of the annual report or minutes, the contents need not be included unless such approval is to be a ratification of the acts described therein. The Commission has no authority to pass on the fairness or merits of plans to be considered at the meeting of the security holders. It can require only a full disclosure.104 But where a soliciting corporation refuses to correct misleading statements, the Commission will supply the stockholders with the additional information.105 Foreign securities are exempt from this section and section 16.106

Section 15 requires that a dealer trading otherwise than on registered exchanges, must obtain registration as an over-the-counter dealer, and that such registration may be denied, revoked, or suspended for stipulated violations.

96. Rule KA 1.
98. Rule KA 5.
100. Rule KB 1.
103. Id. at 1.
106. Rule AN 18.
Brokers whose business is exclusively intra-state are not required to register as over-the-counter dealers. The test whether the business is predominantly intra-state is based on the character of the business, not the market in which the business is transacted.\(^{107}\) The original registration section provided for automatic termination of over-the-counter registrations at the end of 1936, but, as the amendment of May 27, 1936, contains no similar provision, registrations continue indefinitely.\(^{108}\) It has been provided\(^{109}\) that registration of partnerships shall continue for sixty days after the death, withdrawal, or addition of a partner, and that registration of a broker will not lapse by reason of the appointment by the court of a fiduciary for the business. Both these rules are subject to the proviso that a proper application for the privilege must be filed within thirty days of the change in status. Notes and bonds secured by liens on real estate, provided they are not a part of an issue of participation certificates in a single mortgage, are exempt from provisions of this section.\(^{110}\) This relieves brokers dealing exclusively in these securities from the duty of registering. Prompt reports of inaccuracies or changes in the initial application statements are required.\(^{111}\)

**Termination of Over-the-Counter Registration.** There are four situations in which the Commission may deny, suspend, or revoke the over-the-counter registration. **Matter of Securities Exchange Corporation**\(^{112}\) involved the problem of false statements wilfully made. The Commission denied the defense that the application had been signed without having been read by the applicant, and declared that his continuance in business without registration, for eight months after notice, was sufficient to deny registration as within the public interest. Secondly, registrations have been revoked because of registrant's conviction for felonies, such as embezzlement,\(^{113}\) conviction of larceny under a firm name,\(^{114}\) conviction, but not sentence, for larceny,\(^{115}\) selling without a license, and selling overriding royalties as land-owner royalties,\(^{116}\) the latter offense bringing it within the public interest to deny registration. Under the third class, namely, revocation because of an outstanding injunction against the dealer, a consent decree for the injunction assumes sufficient substance to the charge that it is in the public interest to revoke registration.\(^{117}\) However, where the dealer was only under a temporary injunction which has now been vacated, his registration will be reinstated.\(^{118}\) The fourth class includes wilful violations\(^{119}\) of the Securities Act of 1933,\(^{120}\) with the animus evidenced by falsely reporting sales as being lawfully made and, in another case, the ignoring of three notices to desist from improper practices.\(^{121}\) Wilfulness may be determined from the inference drawn from all the surrounding circumstances, as where the defendant deliberately closed his eyes to facts easily ascertainable and of which he had received

\(^{107}\) Release No. 721, June 6, 1936.  
\(^{109}\) Rules MB 4 and MB 5.  
\(^{110}\) Rule AN 22.  
\(^{111}\) Rule MB 2.  
\(^{112}\) Release No. 1305, Sept. 23, 1937.  
\(^{113}\) Matter of Hughes, 1 S. E. C. 843 (1936).  
\(^{115}\) Matter of Grow, Release No. 1219, May 20, 1937 (Respondent was permitted to apply again in six months).  
\(^{116}\) Matter of Natanson, 1 S. E. C. 852 (1936).  
\(^{118}\) Matter of Willson, 1 S. E. C. 402 (1936).  
notice; also where there is a reckless misrepresentation of material facts through gross negligence in adopting the misrepresentations of others.\(^{122}\)

In *Matter of Owen Jones*\(^ {123}\) no notice of the hearing on these charges could be given to the applicant because of neglect to notify the Commission of the change of address; consequently, registration was only suspended. However, where the applicant had consented that notice sent to his original address by registered mail would be sufficient, his failure to receive actual notice did not prevent denial of the application.\(^ {124}\) While investigating charges, the Commission has power temporarily to postpone the effective date of registration pending final disposition.\(^ {125}\)

**Regulation of the Over-the-Counter Dealer.** Manipulative devices under section 15 (c) have been defined in several Rules promulgated by the Commission. Specifically, the term “customer” has been limited\(^ {126}\) to exclude a broker or dealer, \(^ {127}\) and “completing of transaction” has been defined as payment or delivery. “Manipulative devices” are defined\(^ {128}\) as including fraud or deceit, untrue statements or omissions of material facts, representations that the registration indicates approval by the Commission of the business or the merit of the security, failure to notify the customer of the capacity in which the dealer is acting and the name of the other party if the dealer is his broker, failure to disclose control by the broker over the issuer, and advising, without notice of his interest, as to securities in the distribution of which the broker is financially interested. With regard to the last rule, there is no need to distinguish between primary and secondary distribution as the crucial question involves the extent of the broker's interest. The terms are used merely to “exclude the usual types of position trading.”\(^ {129}\) It is unimportant whether the firm effecting the distribution owns the securities, has them under option, is the agent or merely a member of the selling group, as long as the firm has a financial interest.\(^ {130}\)

Further, the manipulative category includes excessive transactions, as to amount and frequency, in the customer’s account by the broker, and neglect on his part to record each transaction.\(^ {131}\) The representation by a broker interested in the distribution of a security, that the security, not having been admitted to trading on any exchange, is offered “at the market” unless some independent market exists is prohibited.\(^ {132}\) Likewise, the use of “pro forma” balance sheets, without explanation of their contents, is forbidden.\(^ {133}\)

Pursuant to section 15 (d), an issuer having securities registered under the Securities Act of 1933 must file supplemental reports with the Commission within 120 days from the close of each fiscal year unless, for good cause, this period has been extended by the Commission.\(^ {134}\)

**Reports by Security Holders.** Pursuant to section 16, directors and officers of an issuer and beneficial owners of more than 10 per cent of the issuer’s securities are required to file reports of any change in their holdings of the issuer’s se-

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126. Rule MC 1.
127. By an opinion of the Director of the Trading and Exchange division, Release No. 1462, Nov. 15, 1937, banks are included.
130. Ibid.
131. Rule MC 7. By Rule OA 1, these records must be preserved.
133. Rule MC 9.
134. Rule ND 1.
securities, to account for profits to the issuer, and are forbidden to engage in short sales. However, the reports filed under this section need be only to one designated exchange if the security is listed on more than one, as the monthly summary of all reports provides adequate information for the public connected with other exchanges. The General Counsel has explained further that in determining the time of making reports, the time of attaining or being divested of beneficial ownership of a security is when a "firm commitment" is taken, or if there is an uncertain condition precedent, at the time the condition is satisfied. The change effected by the re-election or reappointment of an officer or director does not require the filing of a report. Where a husband holds securities in a wife's name, he need file reports as beneficial owner only when he possesses benefits substantially equivalent to ownership, or the power to vest legal title in himself immediately. A similar test may be used when securities are held in the names of other members of the family. Reports are to be made under this section even should there be no net change in amount of securities held, and even though no securities are held at the end of the month. The test as to whether more than 10 per cent of a class of stock is held, is the beneficial interest and not the recorded holding.

The General Counsel has further ruled, with regard to this section, that the beneficiary of an irrevocable personal trust need never report the security holdings of the trust, despite the fact that he might be an officer or director of the issuer. But if the beneficiary is the settlor and has exercised some control over the trust, he may be compelled to render reports. In the event that the trust is revocable, the beneficial owner is the one who holds the power of revocation for his own benefit, either alone, or in conjunction with someone not having a substantial adverse interest. Inasmuch as the test seems to be one of control and benefit, the decisions upholding the taxing of the income of the trust to the settlor might indicate the situations in which the settlor must file reports as beneficial owner of securities held in trust. However, the trustee, if a director or officer of the issuer, must file reports indicating his interest in the case of an irrevocable trust of which he is remainderman.

In determining the ownership of more than 10 per cent of a class of stock, "class" is defined as that part of an issue of stock which has been issued, regardless of whether it is listed, registered or held for the account of the issuer. However, if the security is that of a voting trust, or is a certificate of deposit, the term "class" shall include the entire amount issuable. Furthermore, if the person reporting is not the direct beneficial owner, only the nature of the ownership may be specified. For example, a partner may report either his pro rata share of the firm's holdings or the entire holding with notice of an interest in it as partner. An officer of an issuer may use the same procedure with respect to his share of the partnership holdings. No report is necessary by stockholders in a holding company as to the company's holdings unless such arrangement is merely a medium of trading or investing in securities. In that event, the person in control must report the extent of his interest. The company must also report.

137. Ibid.
142. Supra note 140.
143. Rule NA 2.
144. Rule NA 3.
145. Supra note 140.
146. Ibid.
Exemptions from the provisions of this section for the first two years are provided for securities held in deceased's or guardian's estates.\(^{147}\) Securities held by other fiduciaries administering the assets of another person, securities re-acquired and held by or for the issuer, and securities sold by odd lot dealers as far as is reasonably necessary to carry on the odd lot transactions, are also excepted. This latter ruling has been made because such odd lot dealing usually is non-speculative and the nature of the business requires latitude.\(^{148}\) A further exemption from reports under this section is accorded officers and directors, excepting holders of more than 10 per cent as to securities of holding companies registered under the Public Utility Holding Company Act or their subsidiaries.

Underwriters are exempt from the necessity of accounting under subsection (b) to the issuer for profits made on distribution of securities.\(^{150}\) However, if the underwriter was a director, employee or other representative of the issuer, other persons must have participated in the distribution of at least half of the issue of the security on terms at least as favorable, in order that the underwriter may claim this exemption. Also, an exemption is granted to sales of securities by directors or employees, if the security was purchased pursuant to a right received by virtue of employment by the issuer. Directors or officers are required to report and account for profits in an arbitrage transaction; however, they are exempt from the delivery provisions of subsection (c).

**Procedure before the Commission.** The machinery for investigations and hearings by the Commission to determine violations of the Act is provided for in sections 21 and 22. A full set of Rules of Practice have been promulgated for all proceedings before the Commission. Hearings ordinarily are held in Washington, unless it proves more convenient to hold them elsewhere. In the case of *Matter of Meehan*\(^{164}\) a change of venue to New York was denied, in the discretion of the Commission, in order to permit the Commissioners to attend as many hearings as possible. Application for bills of particulars on charges of illegal use of manipulative devices, to be investigated in the hearings, have been denied where the offense was statutory, and the charge, framed in the wording of the statute, contained all the elements stipulated by the Act.\(^{165}\) However, in this specific instance, the Commission did make available many particulars, but only in an informal manner, so that the evidence would not be limited. Furthermore, in the *Meehan* case, the approximate dates and general types of transactions were furnished the respondent. In denying these requests, the Commission indicated the lack of any real necessity for bills of particulars inasmuch as a continuance was readily available to the respondent.\(^{166}\)

Investigations under section 21 being informal and necessarily secret, the Rules of Practice do not apply and there is no right in the respondent or the witness to be furnished a transcript of his testimony or to bring in a stenographer. This ruling is based on the same theory as the denial of similar rights in grand jury investigations. Under subsection (e), the Commission

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147. Rules NA 4 and NA 5.
149. Rule NA 6.
150. Rule NB 2.
151. Rule NB 3.
152. Rule ND 1.
156. Ibid.